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CHARLES ELMORE

IN THE

Supreme Court of the United States

OCTOBER TERM, 1932

No. 26

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

HENRY HARMEL

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF OF WALTER E. BARTON AS AMICUS CURIAE

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE

May it please the Court:

The undersigned, as counsel for *W. T. Waggoner* and *Ella Waggoner,* respectfully moves this Honorable Court for leave to file the accompanying brief in this case as *amicus curiae.*

WALTER E. BARTON,
Investment Bldg., Washington, D. C.
Counsel for W. T. Waggoner and Ella Waggoner, as Amicus Curiae.

IN THE

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OCTOBER TERM, 1932

No. 26

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v.

HENRY HARMEL

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF OF WALTER E. BARTON AS AMICUS CURIAE

PRELIMINARY

W. T. Waggoner and Ella Waggoner filed appeals from the Commissioner of Internal Revenue to the United States Board of Tax Appeals, raising the question of whether cash considerations received by them in 1922 for the execution of certain instruments, commonly known as "oil and gas leases," on lands owned by them in Texas, which, under the law of Texas, actually conveyed title to the oil and gas in place to the lessee, were taxable gain within the purview of Section 206 of the

Revenue Act of 1921. The Board of Tax Appeals held that such cash considerations were taxable as capital gain and not as ordinary income. (*W. T. Waggoner et al.,* Docket Nos. 33516, 33517, 24 B. T. A. 657.) The Commissioner of Internal Revenue has filed with the Board of Tax Appeals a petition to the United States Circuit Court of Appeals for the Fifth Circuit for review of the order of the United States Board of Tax Appeals, which petition for review has not yet been docketed in the Circuit Court of Appeals for the Fifth Circuit.

The same question that is raised in the instant case is presented in *W. T. Waggoner et al., supra,* and the decision of this Court in the former will determine the issue in the latter.

We shall attempt to show that the judgment of the court below in the instant case should be affirmed.

Opinions Below

The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 20) is reported in 56 F. (2d) 153. The opinion of the Board of Tax Appeals (R. 8-10) is reported in 19 B. T. A. 376.

Jurisdiction

The judgment of the Circuit Court of Appeals for the Fifth Circuit was entered February 23, 1932. (R. 21.) Petition for a writ of certiorari was granted April 18, 1932. Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented

The petitioner states the question to be whether *cash bonuses paid as advance royalties* under oil and gas leases on lands in the State of Texas constitute income from the sale of capital assets within the meaning of Section 208 of the Revenue Act of 1924. (Petitioner's brief, p. 2.)

The findings of the Board of Tax Appeals were that the respondent received "stipulated royalties and a cash consideration of $57,000.00." (R. 8.) The opinion of the Board (R. 9) and the opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 20) refer to the $57,000.00 received as "cash consideration" and not as "advance royalties."

It is respectfully represented that the question presented is:

Whether a cash consideration received by the owner of lands situated in Texas, for the execution of an instrument commonly known as an "oil and gas lease," which, under the law of Texas, actually conveys title to the oil and gas in place to the lessee, is taxable as capital gain under Section 208 of the Revenue Act of 1924?

Statute Involved

Revenue Act of 1924, c. 234, 43 Stat. 253, 162:

> Sec. 208 (a) For the purposes of this title—
>
> (1) The term "capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;
>
> (2) The term "capital loss" means deductible loss resulting from the sale or exchange of capital assets;

(3) The term "capital deductions" means such deductions as are allowed by section 214 for the purpose of computing net income, and are properly allocable to or chargeable against capital assets sold or exchanged during the taxable year;

(4) The term "ordinary deductions" means the deductions allowed by section 214 other than capital losses and capital deductions;

(5) The term "capital net gain" means the excess of the total amount of capital gain over the sum of (A) the capital deductions and capital losses, plus (B) the amount, if any, by which the ordinary deductions exceed the gross income computed without including capital gain;

(6) The term "capital net loss" means the excess of the sum of the capital losses plus the capital deductions over the total amount of capital gain;

(7) The term "ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions; and

(8) The term "capital assets" means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

(b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain.

* * * * * *

(U. S. C., Title 26, Sec. 939.)

STATEMENT

The respondent is an individual residing at Megargel, Texas. (R. 8.) In the year 1924 the respondent was, and had been for many years, the owner in fee simple of certain land in Texas. (R. 8.) In October, 1924, he executed two instruments, commonly known as "oil and gas leases," covering said land, on the basis of stipulated royalties and a cash consideration of $57,000.00. (R. 8.) This cash consideration was returned by respondent as gain from the sale of capital assets under Section 208, Revenue Act of 1924. (R. 9.) The Commissioner of Internal Revenue treated it as income taxable at the ordinary rates. (R. 9.) The Board of Tax Appeals held with the Commissioner (R. 9.), and the Circuit Court of Appeals for the Fifth Circuit reversed the Board. (R. 20.)

The two oil leases referred to above are set out in full in the record. (R. 14-19.)

SUMMARY OF ARGUMENT

1. The question presented is whether a *sale* of capital assets was consummated. Congress did not qualify the word "sale," and, hence, it was used in its ordinary sense. (*U. S. v. Merriam,* 263 U. S. 179.) If the instruments given by the respondent passed title to the oil and gas in place to the lessee, a sale was consummated, as this is the essence of a sale. (23 *R. C. L.* 1186; 55 *C. J.* 36.)

2. It is the settled law of the State of Texas that such instruments convey title to the oil and gas in place to the lessee, which is a *sale* as contemplated by the Act. (*Group No. 1 Oil Corp. v. Bass,* 283 U. S. 279; *Theisin v. Robison,* 117 *Tex.* 489, 502 S. W. (2d) 646; *Texas Co. v. Daugherty,* 107 Tex. 226, 176 S. W. 717; *Stephens Co. v. Mid-Kansas Oil & Gas Co.,* 113 Tex. 160, 154 S. W. 290, cf. *W. T. Waggoner Est. v. Wichita Co.,* 273 U. S. 113.) Hence a sale was consummated by the taxpayer on the execution and delivery of the instruments in question.

3. The federal courts will follow state laws with respect to the title to property. (25 *C. J.* 839; 27 *R. C. L.* 51; 28 *U. S. C. A.,* annotation 143; *Guffey v. Smith,* 237 U. S. 112, 113; *Poe v. Seaborn,* 282 U. S. 101; *U. S. v. Robbins,* 269 U. S. 315; *U. S. v. Malcolm,* 282 U. S. 792; *Crooks v. Harelson,* 282 U. S. 55; U. S. v. *Cambridge Loan & Bldg. Co.,* 278 U. S. 55.)

Work v. Mosier, 261 U. S. 232, chiefly relied upon by petitioner to sustain his argument that bonuses received for the execution of oil and gas leases represent ordinary royalties, is not in point.

The construction of the Act of June 28, 1906, pertaining to Osage Indian lands, and not a Revenue Act, was involved. The question was whether unanticipated bonuses received on the execution of oil and gas leases on these Indian lands should be paid over to the Indians quarterly as "royalties," or kept on deposit in the Treasury of the United States with other Indian monies for a number of years, and only the interest thereon paid over to the Indians. This Court held that it was a matter of statutory construction; and that plain intendment of the Act was that such bonuses were to be paid over quarterly as "royalties."

Cases arising under the Excise Tax Act of 1909 do not help. (*U. S. v. Biwabik Min. Co.*, 147 U. S. 116; *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503; *Strattons' Ind. v. Howbert*, 231 U. S. 399.) They involved the construction of that particular Act, which was an excise tax and not an income tax act.

Stanton v. Baltic Min. Co., 240 U. S. 103, 114, involved the constitutionality of the Revenue Act of 1913, and is not pertinent here.

The question at issue is governed by the decisions of this Court in *Group No. 1 Oil Corp. v. Bass, supra,* and *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 393. Every case, except one, relied upon by the petitioner, involving the question of whether bonuses from oil and gas leases represent proceeds from the sale of capital assets or ordinary royalties, arose in states where it is the settled law that such leases do not pass title to the oil and gas in place to the lessee. The exception is *Hirschi v.*

U. S., 67 Ct. Cl. 637, and the opinion in that case was written before this Court decided *Group No. 1 Oil Corp. v. Bass, supra,* and *Burnet v. Coronado Oil & Gas Co.*

The cash consideration was received by the respondent from the sale of capital assets, and the judgment of the Court below should be affirmed.

ARGUMENT

I

The Cash Consideration Received by the Respondent Was Not a Royalty

The petitioner argues that the cash consideration received by the respondent on the execution of the oil and gas leases in question represented advance royalties, relying chiefly on *Work v. Mosier,* 261 U. S. 232. (Petitioner's brief, p. 6 *et seq.*) This suit arose under the Act of June 28, 1906, and Chief Justice Taft stated the subject matter of the controversy in considerable detail, which we have summarized as follows:

The Act of June 28, 1906, provided for the enrollment of the Osage Indian tribe in Oklahoma Territory, including minors, for the division of the land between them by selection, the selection for the minors being made by their parents, *but forbade the sale of the oil, gas, coal or other minerals underlying the lands,* such minerals being reserved to the use of the tribe for a period of twenty-five years, the royalties to be paid to the tribe. The Act directed that the oil, gas, coal and other minerals should become the property of the individual

owner of the land at the end of that period. Section (3) of the Act directed the leasing of the oil, gas and other mineral rights in the lands by the tribal counsel under rules and regulations of the Secretary of the Interior, the royalties to be paid to the Osage Tribe as determined by the President of the United States. The effect of the Act was to give each member of the tribe three selections of land, all to be farmed by him for twenty-five years and to become his absolute property at the end of that time. Under Section (4), funds belonging to the tribe from various other sources were to be held by the United States as trustee for twenty-five years, and the interest as earned thereon as to be divided among the members of the tribe. In addition, under the second paragraph of Section (4), the royalties received from oil, gas, coal, and other mineral leases, and certain other monies, were to be distributed to the members of the tribe as income, payable quarterly. As the mineral properties became more valuable, the practice was initiated of putting up at auction the privilege of leasing particular mineral properties of the tribe. Large sums as down payments or bonuses in addition to the royalties as fixed by the President were realized for the benefit of the tribe. The Secretary of the Interior held that these bonuses were not royalties subject to be paid quarterly to the tribe as income; but that they were a part of the trust funds to be held in the Treasury of the United States until the end of the twenty-five year period, and that only the interest thereon should be distributed to the members of the tribe.

The question presented to the Court was not whether the bonuses represented capital or income within the meaning of a Revenue Act. The issue was whether it was the intendment of the Act of June 28, 1906, that the unexpected down payments or bonuses should be withheld from the Indians until the end of the twenty-five year period, or whether they should be included in "royalties" as used in the Act and distributed to the members of the tribe quarterly. That the Court decided the question solely from the construction of the Act itself, is clearly indicated by the following language of the Chief Justice, beginning at the bottom of page 359:

> "The question whether bonuses were to be included in royalties is a matter of statutory construction, not finally intrusted to the discretion of the Secretary, but determinable in Court, at the instance of the beneficiaries, as of right."

The petitioner argues that *Work v. Mosier, supra,* has been recognized uniformly where the distinction between bonus and royalty was sought to be made, citing *Alexander v. King,* 46 F. (2d) 235; *Ferguson v. Commissioner,* 59 F. (2d) 891; *Appeal of Nelson Land & Oil Co.,* 3 B. T. A. 315, 326. (Petitioner's brief, p. 10.)

In *Alexander v. King, supra,* the oil and gas leases were made on lands situated in Oklahoma, where the law of the state is that an oil and gas lease does not pass title to the oil and gas in place to the lessee. (*Rich v. Dougherty,* 71 Okla. 204, 177 Pac. 86, 89.) In deciding *Alexander v. King,*

supra, the Circuit Court of Appeals not only held that it was necessary to look to the Oklahoma law to see whether title to the oil and gas had passed to the lessee, but clearly distinguished its decision from *Ferguson v. Commissioner,* 45 F. (2d) 573, which involved oil and gas leases of Texas lands, by pointing out the difference between the laws of Oklahoma and Texas on this question.

In *Ferguson v. Commissioner,* 59 F. (2d) 891, oil and gas leases of Kansas lands were involved, where the law of the state is that such leases do not convey title to the oil and gas in place to the lessee. (*Hoover v. McNeill,* 102 Kan. 492, 175 Pac. 150; *Finch v. Beyer,* 94 Kan. 525, 146 Pac. 1141.) Again the Circuit Court of Appeals for the Tenth Circuit emphasized the fact that title did not pass. We quote from the opinion on page 892 as follows:

> "Such leases did not convey title to the oil and gas in place. They only gave the lessee the right to go upon the land and to prospect for, develop, and remove oil and gas therefrom. Under them the respective lessees would acquire title only to the oil and gas which they extracted and reduced to possession."

In *Appeal of Nelson Land & Oil Company,* 3 B. T. A. 315, a West Virginia oil and gas lease was involved. Under the law of that state, such a lease does not convey title to the oil and gas in place. (*Toothman v. Courtney,* 62 W. Va. 167, 58 S. E. 915; *Smith v. Root,* 66 W. Va. 633, 66 S. E. 1005.)

To sustain his argument that a bonus represents advance royalties, the petitioner cites the follow-

ing cases (Petitioner's brief, p. 10) which do not refer to *Work v. Mosier, supra:*

Burkett v. Commissioner, 31 F. (2d) 667;
Berg v. Commissioner, 33 F. (2d) 641;
Hirschi v. United States, 67 Ct. Cl. 637.

In *Burkett v. Commissioner, supra,* and *Berg v. Commissioner, supra,* oil and gas leases of Arkansas lands were involved. The law of that state is that such instruments do not pass title to the oil and gas in place to the lessee. (*Osborn v. Ark. Ter. Oil & Gas Co.,* 103 Ark. 175.)

All of the foregoing cases cited by the petitioner, with the exception of *Hirschi v. United States,* have reference to oil and gas leases in states where such leases do not convey title of the oil and gas in place to the lessee. The decisions in those cases, therefore, are not inconsistent with the decision of the court below in the instant case, or with the decision in *Ferguson v. Commissioner,* 45 F. (2d) 573. The latter two cases and that of *Hirschi v. United States, supra,* pertain to Texas leases. It is our contention that the *Hirschi* case was erroneously decided, as we shall point out later.

The petitioner criticises the distinction which the Circuit Court of Appeals for the Fifth Circuit made between the bonus and the one-eighth royalty interest in deciding *Ferguson v. Commissioner,* 45 F. (2d) 573. (Petitioner's brief, p. 7.) In view of the decision of the Court in *Group No. 1 Oil Corporation v. Bass,* 283 U. S. 279, and *Theisen v. Robinson,* 117 Tex. 489, 508, 8 S. W. (2d) 646, quoted in this Court's opinion to the effect that an oil and

gas lease in Texas, with one-eighth royalty reserved, conveys title to *all* and not only to seven-eighths of the oil and gas in place to the lessee, it may be possible that the Circuit Court of Appeals for the Fifth Circuit erred in *Ferguson v. Commissioner,* 45 F. (2d) 573, in holding that title to only seven-eighths of the oil and gas passed to the lessee. However that may be, we are concerned in the instant case only with the issue of whether the *cash consideration* or *bonus* was received from the sale of capital assets. Whether it was received for the sale of seven-eighths or of the entire interest of the respondent in the oil and gas in place is immaterial.

The petitioner in support of his contention that bonuses represent advance royalties, cites a number of other cases which are clearly distinguishable from the case at bar. In *United States v. Biwabik Mining Company,* 247 U. S. 116 (Petitioner's brief, pp. 10, 13), it was held that the proceeds of iron ore mined by a corporate lessee of Minnesota lands were income under the Excise Tax Act of 1909; and that the lessee could not deduct as capital invested, the fair market value of the ore in place as of January 1, 1909. This Court pointed out that under Minnesota law, a lessee was not a purchaser of the ore in place, and that this fact was also referred to in *Von Baumbach v. Sargent Land Company,* 242 U. S. 503. In the latter case it was held that royalties received by a corporate lessor of Minnesota lands represented income under the Excise Tax Act of 1909 and not the conversion of investment from ore into

money, following *Strattons' Independence v. Howbert,* 231 U. S. 399. In the last mentioned case this Court held that mining corporations extracting ores from their own premises, were subject to the Excise Tax Act of 1909; that the proceeds from the sale of such ores were income under said Act; and that the difference between the selling price of the ores and the cost of removing the same, was not deductible as depreciation under said Act. If the contention of the taxpayer had been sustained, the effect would have been that there was no income to tax, and this would have frustrated the plain intendment of the Act. (Petitioner's brief, pp. 12, 13, 20.)

In *Stanton v. Baltic Mining Company,* 240 U. S. 103, 114, this Court rejected the taxpayer's contention that the Revenue Act of 1913 was unconstitutional as an unapportioned direct tax when applied to mining corporations, because the five per cent (5%) allowance for depletion was inadequate. (Petitioner's brief, pp. 12, 13.)

The petitioner further argues that his contention that a bonus is an advance royalty is supported by decisions to the effect that lessees may not deduct the entire bonuses as a business expense in the year in which paid, but must amortize the deduction over the life of the lease. (Petitioner's brief, p. 11.) It is respectfully submitted that these decisions do not sustain petitioner's argument, as such bonuses would be deductible ratably over the term of the lease irrespective of whether they were deemed to be advance royalties or considerations for the purchase of the lease.

In view of the foregoing, it is respectfully submitted that the petitioner's contention that the cash consideration received by the respondent on the execution of the oil and gas leases in question represented royalties, is unsupported by the cases referred to in his brief, except *Hirschi v. United States,* which will be discussed below.

II

The Cash Consideration Was Received by the Respondent from the Sale of Oil and Gas in Place to the Lessee

The statute provides—

> "The term 'capital gain' means taxable gain from the *sale* or *exchange* of capital assets consummated after December 31, 1921." (Italics ours.)

It is our contention that through the instrumentality of the leases in question, the respondent sold the oil and gas in place to the lessee.

Congress did not qualify the word "sale" in the statute, and, hence, it was used in its ordinary judicial sense. (*U. S. v. Merriam,* 263 U. S. 179; *Kepner v. U. S.,* 195 U. S. 100, 124; *The Abbotsford v. Johnson,* 98 U. S. 440.)

By sale is meant the transfer of title from one to another. (23 *R. C. L.* 1186; 55 C. J. 36; *Words & Phrases, First Ser.,* Vol. 7, p. 6291; *Second Ser.,* Vol. 4, p. 436; *Third Ser.,* Vol. 6, p. 907.)

In *Five Per Cent Cases,* 110 U. S. 471, 478, the word "sale" was defined as follows:

> "A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent."

We also quote from *Williamson v. Berry,* 8 How. 495, 544:

> "Sale is a word of precise legal import, both at law and in equity. It means at all times, a contract between parties, to give and to pass rights of property for money—which the buyer pays or promises to pay to the seller for the thing bought and sold."

The sole question presented in the case at bar is whether the respondent sold the oil and gas in place to the lessee. This is to be determined by Texas law, as federal courts will follow state law with respect to the title to property. (25 *C. J.* 839; 27 *R. C. L.* 51; 28 *U. S. C. A.,* annotation 143; *Guffey v. Smith,* 237 U. S. 112, 113; *Poe v. Seaborn,* 282 U. S. 101; *U. S. v. Robbins,* 269 U. S. 315; *U. S. v. Malcolm,* 282 U. S. 792; *Crooks v. Harrelson,* 282 U. S. 55; *U. S. v. Cambridge Loan & Bldg. Co.,* 278 U. S. 55.)

It is the settled law of Texas that instruments commonly known as oil and gas leases convey title to the oil and gas in place to the lessee. (*Theisin v. Robison,* 117 Tex. 489, 502, 8 S. W. (2d) 646; *Texas Co. v. Daugherty,* 107 Tex. 226, 176 S. W. 717; *Stephens Co. v. Mid-Kansas Oil & Gas Co.,* 113 Tex. 160, 254 S. W. 290, cf. *W. T. Waggoner Est. v. Wichita Co.,* 273 U. S. 113.)

In *Group No. 1 Oil Corp. v. Bass,* 283 U. S. 279, the question presented was whether the income of

a lessee, derived from an oil and gas lease of state university lands granted by the State of Texas, was taxable by the federal government. The lessee contended that the lease was an instrumentality of the state, and that the income being derived therefrom was exempt from federal income taxation. This court rejected that contention on the theory that the lessee acquired title to the oil and gas in place on the execution of the lease, and that the income was derived from the sale of its own property. We quote briefly from the opinion written by Mr. Justice Stone, as follows:

> "Section 12 of Article 7 of the state Constitution, as interpreted by the highest court of the state, 'requires the legislature to dispose of the university lands by *sale* only.' *Theisen v. Robison,* 117 Tex. 489, 502, 8 S. W. (2d) 646. Leases of university lands like those of petitioner have been held by that court to be in compliance with this provision of the Constitution as present sales to the lessees, upon execution of the leases, of the oil and gas in place. *Theisen v. Robison, supra.* In so construing them, the court applied the settled rule of the state with respect to oil and gas leases. *Texas Co. v. Daugherty,* 107 Tex. 226, L. R. A. 1917F, 989, 176 S. W. 717; *Stephens County v. Mid-Kansas Oil & Gas Co.,* 113 Tex. 160, 29 A. L. R. 566, 254 S. W. 290, cf. *W. T. Waggoner Estate v. Wichita County,* 273 U. S. 113, 71 L. ed. 566, 47 S. Ct. 271. As was said in *Theisen v. Robison, supra,* (117 Tex. 510, 511, 8 S. W. (2d) 646):
>
> " 'They (the leases) do not authorize the purchaser to take and use seven-eighths or any

other mere fractional part of the oil or gas in the land leased. The purchaser instead buys *all* the oil and gas, for a stipulated price, part of the price being measured by the value of a certain fraction of the *produced* oil and gas, which is a very different thing from the value of that fraction of the oil and gas in place. The leases convey all the oil and gas in granting the right to find, produce, and appropriate *all* of them, in consideration of the payment of stipulated sums and also the value of a stated fraction of the oil and gas produced'."

The leases in *Group No. 1 Oil Corp. v. Bass, supra,* and those in the instant case are in all material respects the same. In terms they "grant" and "lease" for a period of years, with renewal privileges, the right to enter on the designated lands for the purpose of "drilling and operating," in the *Group No. 1 Oil case,* and "mining and operating," in the instant case, and to erect and maintain all necessary structures for the production, transportation and storage of the oil and gas. The lessee in *Group No. 1 Oil Corporation* case, was required to pay the lessor the value of one-eighth of the petroleum produced and one-tenth of the gas sold; and in the instant case the lessee was required to pay the lessor the equal of one-eighth part of the oil produced and one-eighth of the value at the wells of the gas, and in addition a cash consideration or bonus. (283 U. S. 281; R. 15.)

In *Burnet v. Coronado Oil & Gas Co.,* 283 U. S. 393, a similar question arose with respect to the income of a lessee, derived from an oil and gas lease from the State of Oklahoma. It was held

that the income was exempt, inasmuch as title did not pass to the lessee on the execution of the lease. We quote from that part of the opinion written by Mr. Justice McReynolds, wherein he refers to the decision of the Court in the earlier case of *Group No. 1 Oil Corp. v. Bass, supra.*

> "And as there distinctly indicated, the exemption claimed by the oil corporation was denied because under the settled rule applied by the Texas Supreme Court, *the oil and gas from disposal of which the corporate income arose had been purchased, not obtained under a lease-title had passed out of the state by a present sale. Status of title was matter for determination under laws of the state as construed and applied by her courts.* In the present cause there is no basis for saying that according to the local law, the transactions between the State and the lessee amounted to a sale. The distinction between cases involving sales and those where leases had been made seemed sufficiently apparent when *Group No. 1 Oil Corp. v. Bass,* was decided, and is not less obvious now." (Italics ours.)

The foregoing decisions of this Court definitely settled the proposition that under Texas law, the instruments in question were deeds, conveying title of the oil and gas in place from the respondent to the grantee, notwithstanding they customarily were designated as leases.

The petitioner, however, attempts to distinguish *Group No. 1 Oil Corp. v. Bass, supra,* from the one at bar (Petitioner's brief, pp. 26, 27, 28), by arguing that under the Texas Constitution, the

only way the state could dispose of its public lands was by means of a sale; that it became necessary to determine what was the actual fact as to the ownership of the property which produced the income; that there is no question presented here of determining the relation between the state and a lessee; that the instant case is concerned with a lease made between private parties; that the question is not whether a federal tax imposes an unconstitutional burden upon the state; but merely whether the income produced by the lease is to be put in one class or another; and that Congress has power to make a classification satisfactory to itself without regard to state law.

It is submitted that the petitioner's attempt to distinguish the *Group No. 1 Oil Corp. v. Bass* case from the instant one completely fails.

In the *Group No. 1 Oil Corp.* case, it was necessary to determine whether title had passed from the state; so, also, in the instant case is it necessary to decide whether title has passed from the respondent in order to ascertain whether a *sale* was made by him. In the former case, it was necessary to determine the relationship between the state and the lessee; and this is true here in order to ascertain whether a *sale* was made by the respondent.

The next proposition made by the petitioner, that the question is whether the income *produced by the leases* is to be put in one class or another, cannot be conceded. The cash payment in question represents the consideration for the transfer of the oil and gas in place to the lessee. This payment was not dependent upon the operation of the

leases, or whether they ever produced any income after the transfers were made. The sole question presented to this Court is whether a *sale* was made by the respondent.

It is conceded that Congress has the power to make a classification satisfactory to itself without regard to State law; but Congress did not do so here. The terms "capital gain," "capital assets," and "ordinary net income" are defined in the statute. Congress thereby indicated that they were to be construed as defined, without regard to the ordinary meaning. The term "sale," however, was not defined; and it must be presumed that it was used in its ordinary sense, i. e., a transfer of title to property.

The petitioner argues that:

> "If the income from an oil and gas lease is to be classified as capital gain when the transaction takes place in Texas but as ordinary income when the transaction occurs in any other state, it is at once apparent that Texas taxpayers will be favored in a way not contemplated by Congress. It is reasonable to suppose that Congress intended the statute to be uniformly applied, since the desirability of the uniform application of Federal statutes is generally recognized." (Petitioner's brief, p. 23.)

This same argument might have been made with greater force in connection with the questions presented in the community property cases (*Poe v. Seaborn, supra*), in the building and loan cases (*Cambridge L. & Bldg. Co., supra*), and in the

estate tax case of *Crooks v. Harrelson, supra;* but this Court held that the law of the state controlled.

The principle that federal courts will recognize state laws with respect to the title to property is very emphatically demonstrated by the decisions of this Court in *U. S. v. Robbins,* 269 U. S. 315, and *U. S. v. Malcolm,* 282 U. S. 792. The question in each case was whether the community income in California was divisible between husband and wife for income tax purposes. In the first case, it was held that it was not divisible, because under California law the wife had a mere expectancy, as contra-distinguished from a vested interest, in one-half of the community property. Subsequent to the *Robbins* decision, the California law was changed, giving a wife vested interest in one-half of the community property; and it was held in the *Malcolm* case that one-half of the community income was returnable each by husband and wife.

The community property decisions turned on the question of whether the wife owned the income, and it was held that the question was determined by state law. In the instant case, it is necessary to determine who owns the oil and gas in place in order to ascertain whether a *sale* was made, and this necessarily depends upon Texas law.

Other cases are cited by petitioner to support his contention that Texas law does not control in the instant case; but we submit that they are not pertinent to the issue.

In *U. S. v. Cambridge L. & Bldg. Co.,* (Petitioner's brief, p. 25), it was held that Congress did not define the term "building and loan asso-

ciation," and, consequently, that it was necessary to look to the state law. This case did not turn on any requirement of the statute to follow state law, but merely on the proposition that Congress did not define the term. Clearly it does not support petitioner's contentions that Texas law should be disregarded in the instant case.

In *Rosenberger v. McCaughn,* 25 F. (2d) 699, the lessor of Pennsylvania lands gave a lease long prior to March 1, 1913, reserving monthly rentals. The Court recognized that under the Pennsylvania law the lease conveyed title to the coal in place to the lessee, and held that a part of the payment represented capital and a part income; but inasmuch as the taxpayer merely contended that the *entire* payments were capital and not income, the findings of the Commissioner of Internal Revenue were not disturbed.

In *Pocahontas Coal Co. v. Commissioner,* 55 F. (2d) 626, (Petitioner's brief, pp. 20, 22), coal leases of West Virginia lands made prior to March 1, 1913, were involved. The Court recognized that under the West Virginia law such leases conveyed title to the coal in place to the lessee, but rejected the taxpayer's contention that the *entire* royalties received from 1920 to 1926 represented capital. No alternative contention was made that the present worth of the royalties on March 1, 1913, represented capital, but merely that the depletion allowance was inadequate. These two last mentioned cases might be applicable to the instant case, if the taxpayer had made the leases in question prior to March 1, 1913, with cash consider-

ation deferred until 1924, and then contended that the entire cash consideration was capital in the year in which received.

In *Burk Waggoner Oil Assn. v. Hopkins,* 269 U. S. 110, (Petitioner's brief, p. 30), in addition to the issue of constitutionality, the question was whether the *Burk Waggoner Oil Assn.,* an unincorporated joint stock association conducting its business as a corporation, should be taxed as a corporation or as a partnership, the taxpayer contending that it was taxable as the latter under the Revenue Act of 1918, inasmuch as under the common law of Texas, it was recognized as a partnership.

In the opinion, this Court called attention to the fact that the Act imposed the tax on partnerships and on corporations; that Congress defined the term "corporation" to include associations; and that Congress evidenced an intent to tax such associations as corporations, where they conducted their business as corporations, irrespective of whether such associations were known as partnerships under state law.

If the Act had not included associations in the definition of "corporation," doubtless the Court would have held that the association was taxable as a partnership; but inasmuch as Congress defined "corporations," to include associations, it was held that it was the intendment of the Act to tax such associations as corporations instead of ordinary partnerships.

In *Weiss v. Weiner,* 279 U. S. 333, the question was whether a lessee of a long term lease acquired

after March 1, 1913, could take a deduction for depreciation of buildings, where he did not pay anything for the lease except an annual rental and did not pay for the buildings on the leased premises. This Court held that he could not, and that it was immaterial that under the Ohio law, where the properties were located, such a lease was treated in many respects as a conveyance of the fee. There was no capital invested or March 1, 1913, value involved, and, hence, no allowable deduction. (Petitioner's brief, pp. 20, 21.)

In view of the foregoing, it is respectfully submitted that the cash consideration was received by the respondent for the *sale* of his oil and gas in place to the lessee and not as advance royalty for the lease of the minerals.

III.

The Cash Consideration Is Taxable As Capital Gain

The record discloses that the respondent owned the fee simple title to the lands in question for more than two years prior to sale. (R. S.) Since the cash payment received by the respondent on the execution of the leases in question represented consideration for the *sale* of the oil and gas in place to the lessee and not ordinary royalties, as contended by the petitioner, such income is taxable as capital gain and not as ordinary income.

The petitioner says, however, that at the time the capital gain provisions first appeared in the Revenue Act of 1921 (c. 136, 42 Stat. 227), the law was settled that mining leases did not con-

vey title to ore in place, citing *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 371, and *Ewert v. Robinson*, 289 F. (2d) 740, 747, and that Congress is presumed to have legislated with this in mind. (Petitioner's brief, p. 14.)

In *Lynch v. Alworth-Stephens Co., supra,* Minnesota leases were involved, and it was held that under the law of Minnesota, such leases did not convey title to the ore in place to the lessee, citing *U. S. v. Biwabik Min. Co., supra,* and *Von Baumbach v. Sargent Land Co., supra.*

In *Ewert v. Robinson, supra,* the action was one of ejectment. The plaintiff claimed that the instrument in question was a lease for years and the defendant contended that it was a mere license or option. The lands were situated in Oklahoma. In passing on the question, the Circuit Court of Appeals for the Eighth Circuit cited a number of decisions of the Supreme Court of Oklahoma to the effect that title to the oil and gas did not pass to the lessee, and also the decisions of this Court referred to above, where Minnesota leases were under consideration.

We do not concede that at the time the first capital gain provision was incorporated into a Revenue Act, it was settled law that mining leases did not convey title to ore in place. It was established law at that time, however, that mining leases did not convey title to the mineral in place to the lessee, contrary to the settled law of the state. In using the term "sale," without statutory definition, the more logical presumption is that Congress legislated with the well established principle in mind, that whether a sale of property is made is

dependent upon the law of the state where the transaction is consummated. Any other rule would work incalculable hardships and produce incongruous results. In the instant case, for instance, if petitioner's contention should prevail, for federal income tax purposes the tax would be levied on the theory that the lessee did not acquire title to the oil and gas in place, whereas in Texas, state and local taxes would be levied on the theory and in accordance with the actual fact that the lessee owned the oil and gas in place. Clearly, there is nothing in the Revenue Act of 1924 which requires a holding that the respondent still owns the oil and gas in place, when in fact and in law he does not.

The petitioner further argues that the avowed purpose of the capital gain provisions supports the construction for which he contends (Petitioner's brief, pp. 16-19); but we submit that the legislative history of the capital gains provisions supports the contention of the respondent.

The purpose of these provisions as expressed in the House and Senate reports accompanying the Revenue Act of 1921, was to encourage the "*sale* of farms, *mineral properties,* and other capital assets," and to increase revenue. (Italics ours.) (H. Rept. No. 350, p. 10, quoted in respondent's brief, pp. 29, 30; S. R. No. 275, p. 12.) The term "capital assets" according to the statutory definition "means property held by the taxpayer for more than two years * * *"; and the Courts have held repeatedly that the term properly includes oil and gas in place. (22 *R. C. L.* 58; 40 *C. J.* 903; 50 *C. J.* 749; *Stephens v. Stephens,* (Ct.

Civ. A. Texas) 292 S. W. 290; *Stephens Co. v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 254 S. W. 290.) Clearly the petitioner can derive no comfort from legislative history of the Act.

The petitioner seeks to limit the application of the term "sale of capital assets" to a transfer of property in which the owner parts with his *entire* interest for a consideration, and to exclude its application from a situation in which the owner retains an interest in the land. The statute refers to the "sale or exchange of capital assets," without any restriction that it shall apply to a sale or disposition of the entire interest of the owner, and that it shall not apply where the owner retains an interest in the land. We submit that there is no logical basis for such a narrow construction of the Act, especially where the avowed purpose of it was to encourage sales of "farms, mineral properties and other capital assets," and to increase revenue.

With reference to petitioner's contention that the respondent "needed no encouragement from the statute to lease his lands, for there could be no *capital gain* realized from the enhanced value of the property subject to tax"; (Petitioner's brief p. 18) it is sufficient to reply that it is contrary to sound rules of logic to assume as a premise the identical proposition which is attempted to be proved.

A careful study of the cases cited by the petitioner discloses that *Hirschi v. U. S.*, 67 Ct. Cl. 637, is the only one in conflict with the decisions of the Circuit Court of Appeals for the Fifth Circuit in *Ferguson v. Commissioner*, 45 F. (2d) 573, and the instant case. The facts and the issue in

the *Hirschi* case and the instant one are the same. In the former the Revenue Act of 1921, and in the latter the Revenue Act of 1924 is involved; but these Acts are materially the same.

The Court of Claims held that in accordance with the weight of authority and the decisions of this Court, an oil and gas lease did not convey title to the oil and gas in place, and further that Congress was not limited in the selection of subjects for taxation by the construction of state Courts as to the property rights of individuals.

The *Hirschi* case was decided before this Court decided *Group No. 1 Oil Corp. v. Bass, supra,* and *Burnett v. Coronado Oil & Gas Co., supra;* and it is reasonable to assume that that Court would reach a different conclusion if the question were to be presented again.

We take no exception to the Court of Claims' statement that Congress was not limited in the selection of subjects for taxation by the construction of state Courts as to the property rights of individuals; but we submit that that question was not an issue in the *Hirschi* case or in the one at bar. The matter is one solely of construction and not of power.

We respectfully submit that the judgment of the Court below should be affirmed.

Respectfully submitted,

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